4
Future Central Government Capital Needs

China's leaders can be criticized for many sins, but lack of ambition is not one of them. Today, in addition to everything else, they are trying to send a man to the moon, divert half the flow of the mighty Yangtze River by a thousand miles, build a railway over the permafrost to Tibet, construct facilities for the 2008 summer Olympic games,[1] bulk up their armed forces with the latest weaponry, build a telecommunications backbone from one end of the country to another, alleviate poverty for tens of millions and provide essential social services for many more, recapitalize the banking system, and create new cities across the interior. There are thousands of projects, some large and others small. They all, however, share one need: they require central government funding.

Figure 4.1
Estimated Expenditures, Revenues, and Deficits
2002-2005
(US$bn)

	2002	2003	2004	2005
Expenditures				
Agriculture	20.1	21.1	23.1	25.4
Education, Etc.	59.3	60.8	60.8	59.0
Defense and Public Security	85.0	102.0	112.2	112.2
Fiscal Stimulus				
and Economic Development	89.4	98.3	108.1	119.0
Bank Recapitalization	0.0	0.0	34.5	34.5
Social Security	8.2	9.4	10.8	12.5
Government Administration	61.4	64.5	65.1	65.8
Other	7.7	7.8	7.9	7.9
Total Expenditures	331.1	363.9	422.5	436.3
Revenues	292.7	304.0	291.1	277.0
Deficits	38.4	59.9	131.4	159.3

What will China spend during the balance of the current five-year plan? This report's predictions for 2002-2005 are contained in Figure 4.1.[2]

The level of spending for 2002 shown in Figure 4.1 is substantially above the corresponding levels reported by the Ministry of Finance[3] for several reasons. Most important, provincial off-budget expenditures are included (as are "extra-budgetary revenues," which are described above). The central authorities undoubtedly do not know the full extent of revenues and expenditures at local levels and, therefore, produce numbers that do not capture these items. The extent of these expenditures and revenues are not known, and the figures in this report are the result of guesswork and intuition rather than precise estimation. Moreover, the numbers in this report include estimates of military receipts and expenditures that are not included by the central government in the budget (in other words, expenses not hidden in line items for other expenditures).

This report believes that central government leaders, whatever they may think this month, will spend beyond what they currently contemplate in the following years. Why? First, they are obsessed with maintaining social order, and, apart from resorting to the use of force, they often try to buy peace by making piecemeal economic concessions to demonstrators and other disaffected elements.[4] In the future, there will be more unrest than they now anticipate--so there will be more costs in buying off the mobs. More important, Chinese officials will also try to head off future protests by spending funds to alleviate the worst consequences of unemployment and other economic ills. Today, they underestimate the effects that WTO accession will have. Therefore, maintaining stability means doling out cash on an even grander scale. As some have remarked, the central government seems to have switched its emphasis from reform to development during Zhu Rongji's tenure as premier. What we will see in the next few years will be merely an acceleration of an existing trend, not a new one.

Second, Beijing technocrats will not be able to raise as much money in domestic and global equity markets as they had originally planned. The primary reasons are the anomalous state of the domestic markets and increasing wariness in the global ones. The fallout from the fall of Enron will hit Chinese offerings especially hard, as financial results reported by China's companies are the result of bad accounting and unexplainable practices. The scandal started in Houston will delay enterprises from reaching the international markets for at least a half year.

Moreover, news of declining economic performance and social unrest must affect the world's perception of Chinese country risk, and therefore, the world's appetite for Chinese stock. Even the Hong Kong market, which has become desensitized to problems in China, will eventually be affected. As enterprises are less able to raise money, the state will have to spend to take up the slack. For example, central authorities will need to disburse more for pension and other social security costs and, to the extent permissible under World Trade Organization rules, for subsidies for modernization and other purposes.

And there is one other important reason why equity offerings will be delayed: politics.

The deferral of the Bank of China (Hong Kong) offering and especially its New York tranche[5] is only the first of this year's postponements of equity fund raisings outside the Mainland. Because senior leaders in Beijing want Bank of China to be the next large offering, all the others now must wait patiently in line. As a result of this continuing political interference, analysts say that there will only be three large listings in foreign markets this year.[6]

Third, central government officials will have to recapitalize the state banks. Beijing has taken US$157.0 billion of bad and nonperforming loans off the books of the Big Four and an additional US$12.1 billion in loans from the policy banks. Yet this is only the first step. As noted in Appendix 2, the state has yet to pay for these assets.

The Big Four don't have much time because accession to the World Trade Organization means foreign competition will take their best customers, depositors, and employees if these state banks don't remain competitive. Central government leaders can continue to defer fixing the Big Four, but the result for state officials will be catastrophic if they permit foreign institutions to solve the problem for them. As noted, foreign banks are not waiting for the end of the five-year WTO transitional period to begin their run at the state banks. A real clean-up of these domestic institutions will be expensive, but the alternative for Beijing will be so much worse. As we have seen so far, the central government is nonetheless continuing the band aid approach and trying to get by with as small a financial commitment as possible.

That plan is not realistic, however. For one thing, Zhu Rongji said this March that the banks need a new round of funding, the third in a half decade. More important, the asset management company plan of selling off bum debt is not producing expected returns. In addition, planned offerings of stock in the Big Four are being delayed by the aftershocks of the Wang Xuebing scandal. At some point, central leaders will have to face the inevitable: they will have to shell out big sums to rehabilitate the banks. This report believes that they will begin doing so in 2004, as can be seen in Figure 4.1.

Fourth, pension and other social security costs will become the hot topic in coming years. The massive protests in Daqing in Heilongjiang Province had hardly ended early last month when a similar worker demonstration erupted in Lanzhou, the capital of poor Gansu Province.[7] Again the issue was severance payments from a unit of oil giant PetroChina. There have been other recent protests against this enterprise in Liaoning, Hebei, and Shandong Provinces. The demonstrations spread through word of mouth and the Internet because state media was prohibited from carrying stories about worker protests.

The central government, if it wishes to avoid an uncontrollable outburst of similar demonstrations, will have to accept even more responsibility for these unfunded costs. As explained above, the state will not be able to raise these sums in sufficient quantities from its domestic equity markets, at least not anytime in the next few years. These costs must be met now, well before Beijing figures out how to fix its sagging stock markets. This report predicts that expenditures of this sort will increase substantially in the next few years. As can be seen in Figure 4.1, no expense other than that for bank recapitalization will go up by a bigger percentage than social security expenditures.

A final note on spending plans: many leaders in Beijing will be alarmed by increasing government expenditures, especially as revenues begin to decline in 2004 due to a downturn in the economy. There will be pressure to moderate spending plans for 2005 so as to narrow a large anticipated deficit, but no big government budget can be revised so quickly. The result will be two large budget deficits in 2004 and 2005. Efforts to harmonize outflows and inflows will be successful, if at all, only in the next five-year plan.

Government spending, therefore, will be on an upward path for the balance of the current five-year plan. How will the state pay for all its needs? In all likelihood, foreign direct investment will trend downwards because of declining economic performance and fears of devaluation. Equity markets will be stingy for the reasons noted above. So those sources of funds will not help much.

What will the state do? First, there will be some raiding of the huge foreign exchange reserves. We know that the reserves are already being put to use to support local banks, as described above. In tough times the central government will draw down even more from its stash. Nonetheless, this tactic will not be a preferred choice because of how it will appear both at home and abroad.

Second, Beijing will print money at a faster clip. Almost all governments resort to this short-term tactic at some point. Chinese leaders, remembering the inflation of the pre-Tiananmen period, will be hesitant to let the presses run for too long, however. In China, a loose monetary policy carries political overtones that are difficult for leaders to forget.

Third, the People's Republic will borrow more because there will be no other option that can raise funds so quickly. Today, China can tap domestic and foreign money with ease. Figure 4.2 shows the relatively low level of announced sovereign borrowings, both domestic and foreign, in the last three years.

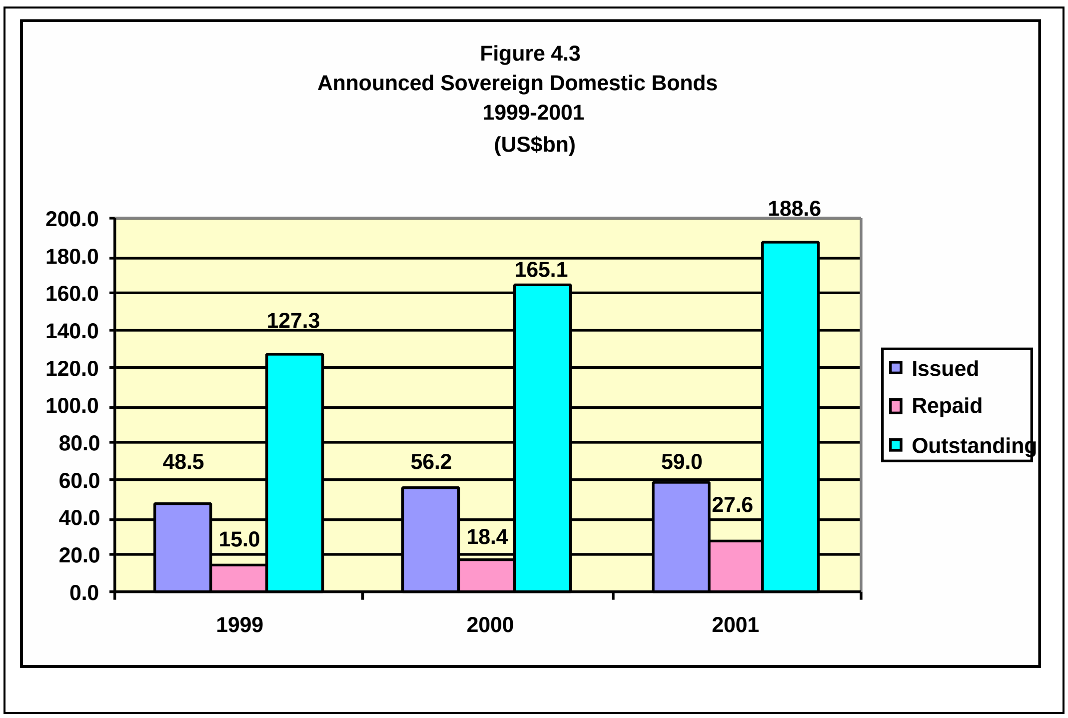
Figure 4.2
Announced Foreign and Domestic
Sovereign Borrowings

1999-2001
(US$bn)

1999	2000	2001
48.5	59.0	59.0

source: China Securities and Futures Statistical Yearbook 2002
People's Bank of China
Almanac of China's Finance and Banking 2001

A comparison of Figure 4.2 and Figure 4.3 shows that most of China's borrowings during the 1999-2001 period took place at home. During this time the country borrowed abroad only in 2000 (and then only to the tune of US$2.8 billion).



source: China Securities and Futures Statistical Yearbook (various years)

As this report indicates, the fiscal needs of the central government will increase dramatically in 2004 and 2005 due to the recapitalization of the banks. As China seeks to borrow more and more tomorrow, foreign lenders will stay clear of new issues of Chinese debt. The only option for the Ministry of Finance will be to look toward creditors at home. Domestic parties will continue to absorb treasury offerings because either there will be few better deals available (thanks to the failure of reform) or because the central government will use its considerable powers of persuasion (appeals to nationalism and worse). The banks, ironically, will be buying the paper that finances their rehabilitation.

Figure 4.4 shows projections of sovereign borrowings through the end of the current five-year plan. Today some may be puzzled why senior officials increasingly use “grim” and “grave” when they talk about the economy. One look at the increased borrowings in 2004 and 2005 will explain their downbeat outlook.

Figure 4.4
Estimated Domestic and Foreign
Sovereign Borrowings
2002-2005
(US$bn)

2002	2003	2004	2005
66.5	87.0	149.5	164.5

Elevated spending will have a positive effect on GDP growth. Although stimulus will be increasingly ineffective, increasing amounts of it will nonetheless boost output to some limited effect. This type of central government intervention is not sustainable, but leaders in Beijing will be able to continue their program during the current five-year plan. The costs of funds, however, will rise sharply as sovereign debt floods China.

As China becomes a more modern country, Beijing’s financial needs will generally increase. So far, technocrats in the Chinese capital have been able to skillfully maintain a balance between the country’s requirements and the resources to meet them. Yet as the People’s Republic heads into its most challenging period, calls on the central treasury will be much larger than in the past. Soon central leaders will be able to precisely quantify the price for their recent failures to implement structural reforms.

[1] construct facilities for the 2008 summer Olympic games: The 2008 Summer Olympics will cost over US$36 billion. Michael Forsythe, “Beijing May Sell 1000 Bln Yuan in Olympic Bonds, Paper Says,” bloomberg.com, April 6, 2002.

[2] This report's predictions: The numbers in Figure 4.1 include obligations incurred but not paid for such as salaries for officials. The numbers do not include unfunded pension and other social security liabilities described in Appendix 3.

[3] reported by the Ministry of Finance: For the latest information about China's expenditures, see "Full Text of Finance Minister's Budget Report (I)," People's Daily Online, March 17, 2002; "Full Text of Finance Minister's Budget Report (II)," People's Daily Online, March 17, 2002.

[4] they often try to buy peace: *See*, *e.g.*, "Funds for Laid-Off Liaoyang Workers," scmp.com, April 18, 2002.

[5] Talk of the deferral of the Bank of China (Hong Kong) offering: *See*, *e.g.*, Joe Leahy and Richard McGregor, "Officials at Chinese State Bank Steal Dollars 500m," *Financial Times*, March 16, 2002, p. 9.

[6] there will only be three large listings: Bill Savadove, "Beijing Gives Hand to BOC Share Offer," scmp.com, May 7, 2002.

[7] Lanzhou: Andrew Batson, "PetroChina Worker Protests Spread to Gansu Province--WP," Dow Jones Newswires, April 24, 2002.